

General Information Letter: Petition for alternative apportionment under IITA Section 304(f) denied. The petition contained no evidence showing that the rule for apportioning partnership income in the hands of a partner failed to reflect the partner's business activities within Illinois.

May 15, 2000

Dear:

This is in response to your letter dated February 22, 2000, in which you request permission to use separate accounting rather than the statutorily-mandated apportionment formula, pursuant to Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 101 et seq.). The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed. For the reasons discussed below, your petition cannot be granted at this time.

In your letter you have stated the following:

As a follow-up to our telephone conversation, I am writing to you on behalf of my client, xxxxxxxxxxxxxxxxxxxxxxxxx, to request the use of a separate accounting (rather than general apportionment) with respect to the partnership's accounting for its multi-state operation. 1999 is the first year for which xxxxx will be filing in Illinois.

xxxxx currently has approximately 200 partners in 10 states, providing part-time, full-time and out-source CFO services to its corporate clients. The partnership's revenue is typically derived from one of two types of arrangements: (1) co-employment relationships, and (2) project work. In the co-employment arrangement, the client company pays a salary directly to the working partner on the account and also pays an administrative fee to the partnership. For project work, the client company pays a fee to the partnership, 75% of which the partnership pays back out to the working partner on the account, and 25% of which is retained by the partnership to cover its operating expenses. The 75% which is paid back out to the working partner is classified for Federal income tax purposes as a guaranteed payment under Section 707(c) of the Internal Revenue Code. The residual, if any, which is left over after the payment of operating expenses is treated as distributive share, and is allocated to equity partners based upon their ownership percentage. Because the business is relatively new and is rapidly expanding, it presently does not have any net income in excess of the guaranteed payments, and, in fact, will probably sustain an operating loss (after payment of guaranteed payments) for 1999 and 2000. Accordingly, all income reported by the partners for 1999 and 2000 will likely be in the form of Section 707(c) payments.

The partnership maintains one or more offices in each of the states in which it operates. Each office maintains a separate P&L. Typically, a partner provides services only through the office which is located in his or her state of residence, and only to clients which are located in such state. Accordingly, all of a particular partner's income is generally attributable to activities performed in his or her state of residence, and, conversely, all of the income

derived from a particular state is typically attributable to and allocated to partners who are resident in such state.

Based upon the foregoing, we believe that the most appropriate manner to report the partnership's activities for state income tax purposes is to utilize separate accounting on an office-by-office basis, reporting as Illinois taxable income that income which was derived in Illinois, with such being allocated to the partners who are resident in Illinois, except to the extent there exists a residual in excess of the guaranteed payments, in which case such would be allocated in part to nonresident partners. Utilizing this method, all income which is derived in Illinois will be reported on Illinois income tax returns, and subjected to Illinois income tax.

In a telephone conversation on April 20, 2000, you stated that the real issue is not how the income of xxxxxxxxxxxxxxxxxxxxxxxxxx is apportioned pursuant to the IITA, but rather with having each partner in xxxxxxxxxxxxxxxxxxxxxxxxxx pay Illinois income tax on his or her partnership share of the income apportioned to Illinois. The relief you seek is to allow each partner to be treated as directly earning his or her share of the income derived from his services, and to allocate such income to the state in which he or she performs the services, while apportioning any income of the partnership net of these directly-allocated amounts using the standard apportionment rules.

#### **Response**

Section 304(f) of the IITA provides:

If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:

- (1) Separate accounting;
- (2) The exclusion of any one or more factors;
- (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Taxpayers who wish to use an alternative method of apportionment under this provision are required to file a petition complying with the requirements of 86 Ill. Adm. Code Section 100.3390, which may be found on the Department's web site at [www.revenue.state.il.us](http://www.revenue.state.il.us).

IITA Section 305(a) provides that:

The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their

respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State.

IITA Section 305(c) provides that a partnership shall allocate and apportion its base income pursuant to the provisions of Article 3 of the IITA in the same manner as a nonresident. IITA Section 304(a) provides the general rule for apportionment of business income of a nonresident.

In our opinion, you have not shown that the application of the general allocation and apportionment rules to xxxxxxxxxxxxxxxxxxxxxxxx and its partners does not fairly represent the Illinois business activity of its partners.

Under Illinois law, a partnership is "a contractual relationship of mutual agency which is formed to carry on a business purpose." *Acker v. Dept. of Revenue*, 116 Ill.App.3d 1080, 1083 (First District 1983). Consistent with the characterization of a partnership, for Illinois income tax purposes, "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners" whose income is taxed to each partner "as if the partnership were merely an agent or conduit through which the income passed." *Id.*

Application of these principles to xxxxxxxxxxxxxxxxxxxxxxxx means that its income is earned by the partnership, not by the individual partners. Moreover, the property and employees located at each office are the property and employees of the partnership, not of the office or of the partners working at that office. Accordingly, each partner is entitled to his or her distributive share of the partnership income from every source and should be taxed on that basis.

Accordingly, it appears that the provisions in the Illinois Income Tax Act for allocation and apportionment of partnership income correctly reflect the Illinois business activity of xxxxxxxxx xxxxxxxxxxxxxxxx and of its partners, and no alternative allocation or apportionment method is called for under IITA Section 304(f).

Please note that 86 Ill. Adm. Code Section 100.3390(e)(1) requires a petition to be filed at least 120 days prior to the due date (including extensions) for the first return for which permission is sought to use the alternative apportionment method. A petition filed February 22, 2000, will allow a taxpayer to use the requested method on original returns due on or after June 21, 2000, if granted.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you still believe that your petition should be granted, please supplement the petition in accordance with the provisions of 86 Ill. Adm. Code Section 100.3390.

Sincerely,

Paul S. Caselton  
Deputy Chief Counsel -- Income Tax